FILE COPY

Office Supreme Court
FILED
DEC 15 19
CHARLES ELMORE C
CL

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 270.

THE PACIFIC CO., LTD.,

Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California,

Appellee.

BRIEF FOR APPELLANT

STUART CHEVALIER,
Counsel for the Appellant.

MELVIN D. WILSON,
MILLER, CHEVALIER, PEELER & WILSON,
Of Counsel.

INDEX

	PAGE
Opinions Below	1
Jurisdiction	1
Question Presented	2
Sections of Constitution and Statute Involved	2
Statement	5
Specifications of Error to be Urged	6
Summary of Argument	7
Argument:	8
I. The Deliberate Legislative Purpose to Raise a Substantial Amount of Revenue by Specifically Taxing the Income from Exempt Bonds, is abundantly shown by the History of this Legislation, as well as by the Face of the Statute itself	9
II. The Constitutional Principles Applied in Macallen Co. *v.* Massachusetts are Conclusive of this Case	21
Bonds of Political Subdivisions of the State	24
III. Other Leading Decisions of this Court Plainly Show that Appellant is Entitled to Prevail in this Suit	27
Conclusion	32

CITATIONS

CASES:

Aberdeen, etc. Assn. *v.* Chase, 157 Wash. 351; 289 Pac. 536	13
Almy *v.* California, 24 How. 169	32
Alpha Portland Cement Co. *v.* Massachusetts, 268 U. S. 203	32
Bank of California *v.* Richardson, 248 U. S. 476	10
Bronson *v.* Kinzie, 1 How. 311, 318	26
Choctaw & Gulf R. R. *v.* Harrison, 235 U. S. 292	31
Cook *v.* Pennsylvania, 97 U. S. 566	32
Educational Films Corp. *v.* Ward, 282 U. S. 379	27-29
Fairbank *v.* United States, 181 U. S. 283	32
Federal Land Bank *v.* Croslan, 261 U. S. 374	32
Flint *v.* Stone Tracy, 220 U. S. 107	28, 29, 30
Frick *v.* Pennsylvania, 268 U. S. 473	32
Galveston, etc. Ry. Co. *v.* Texas, 210 U. S. 217	31
General Securities Co. *v.* Williams (Tenn.) 29 S. W. (2nd) 662	13

in compliance with paragraph 1 of Rule 12, to which "Statement as to Jurisdiction on Appeal", reference is hereby made.

Question Presented.

Is it within the constitutional power of the State of California to impose a so-called franchise tax insofar as it is based upon income from bonds expressly exempt from tax by the State constitution at the time of their issuance, where the deliberate purpose to tax such exempt income is shown by the legislative history of the act and by the face of the statute itself?

Sections of Constitution and Statute Involved.

Section 1¾ of Article XIII of the Constitution of California, in effect when the bonds involved herein were issued, provides as follows:

> "All bonds hereafter issued by the state of California, or by any county, city and county, municipal corporation, or district (including school, reclamation, and irrigation districts) within said state, *shall be free and exempt from taxation*". (Italics ours throughout this brief.)

Following an exhaustive study of the California Tax Commission, an amendment to the Constitution was adopted on November 6, 1928. We quote the following provisions from this amendment, being Section 16, Article XIII of the California Constitution:*

> "Notwithstanding any other provision of the constitution:

*The amendment will be found set forth in full on page 77 of the "Final Report of the California Tax Commission" of March 5, 1929 filed with the briefs herein.

"1. (a) Banks, including national banking associations, located within the limits of this state, shall annually pay to the state a tax according to or measured by their net income, which shall be in lieu of all other taxes and licenses, state, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property. The amount of the tax shall be equivalent to four per cent. of their net income.

• • • • •

"(c) If it be finally determined that any tax levied upon or respecting any bank, national banking association, or the shares thereof, is invalid, said bank or association, or the shares thereof, shall be reassessed in conformity with any method provided by law. No claim against the state for refund or rebate of taxes paid shall be allowed without first deducting therefrom the amount of any such unpaid reassessment.

"2. (a) All financial, mercantile, manufacturing and business corporations doing business within the limits of this state, subject to be taxed pursuant to subdivision (d) of section 14 of this article, in lieu of the tax thereby provided for, shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income. The amount of such state tax shall be equivalent to four per cent. of their net income. Such tax shall be subject to offset, in a manner to be prescribed by law, in the amount of personal property taxes paid by such corporations to the state or political subdivisions thereof, but the offset shall not exceed ninety per cent. of such state tax. In any event, each such corporation shall pay an annual minimum tax to the state, not subject to offset, of twenty-five dollars.

• • • • •

in compliance with paragraph 1 of Rule 12, to which "Statement as to Jurisdiction on Appeal", reference is hereby made.

Question Presented.

Is it within the constitutional power of the State of California to impose a so-called franchise tax insofar as it is based upon income from bonds expressly exempt from tax by the State constitution at the time of their issuance, where the deliberate purpose to tax such exempt income is shown by the legislative history of the act and by the face of the statute itself?

Sections of Constitution and Statute Involved.

Section 1¾ of Article XIII of the Constitution of California, in effect when the bonds involved herein were issued, provides as follows:

> "All bonds hereafter issued by the state of California, or by any county, city and county, municipal corporation, or district (including school, reclamation, and irrigation districts) within said state, *shall be free and exempt from taxation*". (Italics ours throughout this brief.)

Following an exhaustive study of the California Tax Commission, an amendment to the Constitution was adopted on November 6, 1928. We quote the following provisions from this amendment, being Section 16, Article XIII of the California Constitution:*

> "Notwithstanding any other provision of the constitution:

*The amendment will be found set forth in full on page 77 of the "Final Report of the California Tax Commission" of March 5, 1929 filed with the briefs herein.

"1. (a) Banks, including national banking associations, located within the limits of this state, shall annually pay to the state a tax according to or measured by their net income, which shall be in lieu of all other taxes and licenses, state, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property. The amount of the tax shall be equivalent to four per cent. of their net income.

* * * * * *

"(c) If it be finally determined that any tax levied upon or respecting any bank, national banking association, or the shares thereof, is invalid, said bank or association, or the shares thereof, shall be reassessed in conformity with any method provided by law. No claim against the state for refund or rebate of taxes paid shall be allowed without first deducting therefrom the amount of any such unpaid reassessment.

"2. (a) All financial, mercantile, manufacturing and business corporations doing business within the limits of this state, subject to be taxed pursuant to subdivision (d) of section 14 of this article, in lieu of the tax thereby provided for, shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income. The amount of such state tax shall be equivalent to four per cent. of their net income. Such tax shall be subject to offset, in a manner to be prescribed by law, in the amount of personal property taxes paid by such corporations to the state or political subdivisions thereof, but the offset shall not exceed ninety per cent. of such state tax. In any event, each such corporation shall pay an annual minimum tax to the state, not subject to offset, of twenty-five dollars.

* * * * * *

"5. The Legislature shall define . . . 'net income' and may define it to be the entire net income received from all sources. . . ."

In pursuance of this amendment, the Legislature, in 1929, enacted the so-called "California Bank and Corporation Franchise Tax Act." (Stats. 1929, chap. 13, p. 19). It is sufficient to quote here the following provisions of that Act:

"Sec. 4. Every financial, mercantile, manufacturing and business corporation doing business within the limits of this state, of the classes referred to in subdivision 2 (a) of section 16 of article thirteen of the constitution of this state, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of four per centum upon the basis of its net income for the next preceding fiscal or calendar year.

"Each such corporation shall be entitled to an offset against said franchise tax, in the manner hereinafter provided, in the amount of taxes paid upon its real and personal property to any county, city and county, city, town, or other political subdivision of the state, but the total offset shall not exceed seventy-five per centum of the said franchise tax, and in no case shall the taxpayer be entitled to offset more than ten per centum of its said real property taxes.

"In any event, each such corporation shall pay annually to the state, for the said privilege, a minimum tax of twenty-five dollars. . . .

* * * * *

"Sec. 6. The term 'gross income', as herein used, includes . . . *all interest received from federal, state, municipal or other bonds.* . . .

"Sec. 7. The term 'net income', as herein used, means the gross income less the deductions allowed."

We shall review in another connection the history leading up to this general legislation, including statements by the California Tax Commission and others, showing that one of the *"major results"* sought to be accomplished thereby was to include for taxation, "if legally possible, interest from tax exempt securities".

Statement.

The appellant (plaintiff in the Court below) is a financial corporation, organized under the laws of the State of California, and engaged in business in that State. It deals largely in bonds issued by political subdivisions of the State; and during the year here involved received substantial amounts in profits from the sale thereof, and in interest paid thereon.

Appellant, on filing its franchise tax return in August, 1929, for the taxable year 1928, paid a tax of $5,018.48, based entirely upon profits realized on the sale of such district bonds (R. 6). (No question is raised on this appeal as to the validity of this tax.)

On March 17, 1930, the Franchise Tax Commissioner made an assessment of an additional tax against appellant for the taxable year 1928 of $6,692.96, plus interest from the time the tax was due (R. 9). This assessment was arrived at by adding to the tax base the sum of $167,324.11, representing interest which was received by the appellant during the taxable year 1928, on bonds issued prior to November 6, 1928, by various districts of the State of California (R. 9), which bonds were expressly exempt from

taxation at the time of issuance by Section 1¾ of Article XIII of the Constitution above quoted (R. 6, 7).

Thereafter, appellant paid under protest the tax and interest so assessed, and later brought this action to recover such payment, alleging that the tax measured by the interest received from said bonds amounted to a tax on the bonds themselves, and was in violation of Article I, Section 10, of the Constitution of the United States, being an impairment of the obligation of a contract; that the issuance of these bonds, while Section 1¾ of Article XIII of the State Constitution was in effect, constituted a contract between the various districts of the State and the buyers of the bonds, that the bonds would be exempt from all taxation by the State (R. 7).

A demurrer was filed to the amended complaint and was sustained without leave to amend (R. 12), and judgment was entered thereon in favor of the defendant, appellee herein (Rec. 14). Appellant herein then filed an appeal to the Supreme Court of the State, where the judgment of the lower court was affirmed (R. 16), Mr. Justice LANGDON dissenting (R. 26).

The statute under which this tax was assessed was enacted, as shown by its history, for the express purpose of subjecting to tax the income of property which was exempt under the constitutional provision hereinbefore mentioned.

Specifications of Error to be Urged.

The Supreme Court of California erred in holding valid the statute of that State herein involved, imposing a so-called franchise tax, in so far as such tax is expressly based upon interest received from bonds issued by a political subdivision of the State, which bonds were expressly ex-

empt from taxation by the State constitution at the time of issue.

Summary of Argument.

In this case the State of California, having by means of constitutional exemptions induced the purchase by appellant and others of certain bonds issued by its political subdivisions, deliberately set out to reach, by taxation of income, the property so exempted. The means employed was a franchise tax measured by income, with an express provision that income from such bonds was to be included. The clear effect is that holders of the bonds so purchased on the faith of such exemption are, nevertheless, taxed.

That the attempted nullification of the exemption was deliberate, is shown by the State Tax Commission's statement that a "major result" sought by the new legislation was to reach such exempt income, and by the face of the statute itself.

Thus, we are not dealing with a mere incidental or casual effect on such exempt property, but with a case in which the statute was expressly framed for the purpose of reaching such income for taxation, the State having repented of its original bargain.

To prevent such impairment of contracts by the States, Article I, Section 10 was inserted in the Federal Constitution.

The serious effect of the impairment which was suffered in this case is shown by the fact that more than one-half of the franchise tax levied against appellant arises from the inclusion in the taxing base of the interest from these exempt bonds.

The fact that the so-called franchise tax herein was to be in lieu of practically all other personal property taxes

(through the device of offsets) show that in legal and practical effect, this was a direct tax on exempt income and was so intended to be.

This case is even stronger than where a State imposes a tax on Federal securities or where the Federal Government imposes a tax on State securities. The latter situations involve only an implied constitutional prohibition growing out of the relative sovereignties of the taxing jurisdictions and where the invalidity of the tax may depend somewhat upon the degree of the burden imposed thereby; whereas here we are dealing with an absolute and express constitutional prohibition against the impairment of the obligation of contracts.

ARGUMENT.

Article I, Section 10, of the Federal Constitution, was designed to prevent any state from impairing its contractual obligations. When the State of California induced citizens to purchase the bonds of its political subdivisions by constitutionally exempting such bonds from taxation, and then, after the bonds were sold, changed its constitution and its tax system for the purpose of subjecting to tax the very property which it had held out as non-taxable, it did the very thing which the Constitutional provision was intended to stop. The short dissenting opinion rendered by Mr. Justice LANGDON in the court below (R. 26-33) reviews the history of this California legislation and the decisions of this Court on this question. Our contentions are based on the same principles as are relied on in that opinion, and recognized by this Court in *Macallen Co.* v. *Massachusetts*, 279 U. S. 620, and other cases. The facts

in the *Macallen* case were in all material respects identical with those in the case at bar. It appears to be the only decision of this Court involving squarely the question hereinabove stated, to wit, the validity of a state tax "measured by" the income from the state's own tax-exempt bonds, which the state has deliberately and expressly sought to reach and tax by that means; where from the legislative history of the Act and from the language of the Act itself, it is clear that "the avowed purpose and self-evident operation of the statute is to reach such income"; and that the legislature is deliberately "aiming" thereat.

With the utmost deference to the Court below, it is submitted that the majority decision is an erroneous one which was apparently reached through the anxiety of the Court to arrive at a conclusion which would allow the State the additional revenues which it had with such elaborate care set out to get.

1.

The Deliberate Legislative Purpose to Raise a Substantial Amount of Revenue by Specifically Taxing the Income from Exempt Bonds, is Abundantly Shown by the History of this Legislation, as Well as by the Face of the Statute Itself.

The legislative history and the provisions of the statute of California involved will now be considered insofar as they show a deliberate purpose to tax the income of the constitutionally exempt bonds.

California, prior to 1927, imposed a tax on public utili-

ties determined by a percentage of their gross earnings, on insurance companies by a percentage of their gross premiums, on the shares of banks to their shareholders based on a percentage of their capital, surplus and undivided profits, (*Bank of California* v. *Richardson*, 248 U. S. 476), and a tax on ordinary corporations on their "corporate excess". The "corporate excess" was determined by deducting from the market value of the company's capital stock and bonds outstanding, the real and personal property taxed by the subdivisions of the State (Secs. 3664 (d), 3667, 3668, Stats. and Amdts. 1917 Cal. Pol. Code); and the assessment of this "corporate excess" was held to be "an assessment of all the company's so-called intangibles". (*Miller & Lux* v. *Richardson*, 182 Cal. 115.) In arriving at this valuation, there were also deducted bonds exempt from taxation by the laws of the State and Federal Governments. (See opinion of the State Board of Equalization in *Appeal of Vortox Manufacturing Co.*, Prentice-Hall State Corp. Tax Serv. 1930, Par. 11045, and reprinted as an Appendix to this brief.)

In 1927, the legislature, doubting the validity of the state tax on national bank shares, created a Tax Commission to go fully into the matter. The Commission found that the State was in danger of losing millions of dollars of revenue through suits brought by the banks, and as a result of its study, reached the conclusion that the only practicable method of securing substantial revenue from these institutions was to proceed under the fourth method authorized by Section 5219 R. S. (44 Stats. 223; Sec. 548, Title 12, U. S. Code), and tax banks "according to or measured by their net income", and that a corresponding method of taxation be authorized by the legislature

with respect to other financial and business corporations. (Special Report of California Tax Commission, p. 11.)*

It will be recalled that Section 5219 R. S. as revised in 1926 (44 Stats. 223) permits States to tax national banks under any one of the following alternative plans, each of which includes an *ad valorem* tax on the banks' real estate:

(1) A tax on the shares.

(2) A tax on the dividends, included in the taxable income of the shareholders.

(3) A tax on the net income of the banks.

(4) A tax on the business of the banks by a tax "according to or measured by their net income."

With respect to the fourth method, the California Tax Commission said (Special Report, p. 27):

> "As distinguished from the third method, this tax is designed to include within the scope of its application certain types of income *which may not legally be reached by a pure income tax—such as interest on tax exempt government bonds.*"

On page 28, the Commission said:

> "The third method may be discarded in favor of the fourth, because under the fourth everything can be accomplished which may be gained by proceeding under the third, and presumably more besides, viz.: *the inclusion, if desired, of tax exempt interest in the base.*"

---

*"Special Report Dealing with the Taxation of Banks, Corporate Franchises, Securities and Solvent Credits, submitted August 10, 1928", State Printing Office Publication 62125, which will also be found bound in the "Final Report of the California Tax Commission, submitted to the State of California March 5, 1929", beginning on page 243 of the latter report. State Printing Office Publication 63725. For the convenience of the Court, copies of these reports are filed with the briefs herein.

The Commission, after deliberately deciding that the fourth method held the promise of the greatest revenue, because of its apparent authority to tax by indirection constitutionally exempt securities, went on to consider the application of that method to ordinary corporations. Speaking of financial corporations, such as the appellant herein, the Commission said (Special Report, p. 12):

> "While the taxation of the banks at the rate of 4 per cent. on the proposed income base will produce much less than the present yield of the tax on bank shares, nevertheless, the proposed new franchise tax on corporations *will result in greatly increased taxes for a group of financial corporations,* many of them owned by or affiliated with large banks, and the new taxes from this group will probably offset much of the expected loss in bank taxes. The new plan will not materially change the amount of the taxes for merchants and manufacturers, considered as groups."

That the revenue to be derived from the taxation of income from exempt bonds was regarded as of great importance to the State, is further clearly shown on page 40 of the Special Report of the Commission, wherein it said:

> "But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed. An analysis of the replies of the banks to the Commission's questionnaire indicates that the *non-inclusion of federal bond interest would reduce the tax base of the banks approximately one-fourth and the non-inclusion of all interest exempt from the feleral income tax would reduce that base by more than one-half.*"

It seems clear that any method which would increase taxes from a group of taxpayers one hundred per cent. is

not merely casual and incidental, but extremely important. A very substantial part—more than one-half—of the total franchise taxes exacted from appellant was based on income from tax-exempt bonds. Appellant is one of the group of financial corporations whose franchise taxes the Commission, as above quoted, said would be greatly increased by the new law. (Special Report, p. 12.) Certainly it cannot be said either from the standpoint of the State or of the taxpayer that the "burden put upon the non-taxable subject by its use as a measure of value was fortuitous and incidental". (See *Macallen Co.* v. *Massachusetts*, 279 U. S., p. 628.)

The Commission was fully aware of the doubtful legality of the proposed procedure and that it had been questioned in the then pending *Macallen* case. On page 33, the Commission said:

> "Before taking up these questions, it may be pointed out that the system under analysis is not entirely novel and untried. Similar taxes have already been adopted in New York and Massachusetts."

And on page 40 of the Report the Commission said:

> "As has been pointed out (page 23), the 1926 amendment to section 5219 was drafted with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax exempt bonds. The point, however, has not been adjudicated and a suit (*Macallen Company* v. *Commonwealth*) has already been filed in Massachusetts questioning the right of a state to include such interest."*

*It may be of interest to mention that subsequent to the date of this report, the Washington Supreme Court held invalid a similar statute of that State. *Aberdeen, etc. Assn.* v. *Chase* (1930), 157 Wash. 351; 289 Pac. 536. See also *Quicksafe Mfg. Co.* v. *Graham* (Tenn.), 29 S. W. (2nd) 253 (1930); *General Securities Co.* v. *Williams* (Tenn.), 29 S. W. (2nd) 662.

But before legislation along these lines could be enacted, it was necessary to amend the constitution of the State. The Commission drafted such an amendment which was adopted by popular vote on November 6, 1928. The language of the Commission, in submitting its draft of this constitutional amendment for approval, is very significant in this connection. We quote as follows from page 55 of the Special Report:

> "In preparing this draft it has been the intention of the Commission *to further the accomplishment* of the following *major results*:
>
> "(1) To eliminate the present tax on bank shares and in the future to tax banks 'according to or measured by' their net income, this net income to be defined by the legislature in accordance with the authority granted by section 5219 of the Revised Statutes, in such manner as to 'include the entire net income received from all sources', including, *if legally possible, interest from tax-exempt securities,* the banks continuing, as at present, to pay taxes on their real property.
>
> "(2) To supersede the present so-called 'franchise' or corporate excess tax authorized by subdivision (d), section 14 of Article XIII with a true franchise tax payable by all corporations doing business in the state, other than banks, such public utilities as are subject to the present gross receipts taxes, and insurance companies, the value of the franchise *to be measured by their net income, which is to be defined as in the case of banks.*
>
> "(3) To permit a credit or offset against the proposed new franchise tax on corporations for such state and local personal property taxes paid by such corporations in California as are properly attributable to the accounting period covered by the return of net income by which the new franchise tax is measured, but

to impose a minimum state tax of $25.00 even though the amount of the offset should exceed the franchise tax found to be due.

* * *

"(6) To require a reassessment of banks, or their shares, in the event that the state tax assessed against banks, or their shares, be invalid, the reassessment to be in accordance with any method made available by the congress for the taxation of national banks, or their shares, at the time of the invalid assessment."

Here was a deliberate purpose to reach the income from these tax exempt securities, "if legally possible", in the hands not only of the national banks, but of other banks and corporations doing business in the State.

Following the adoption of the constitutional amendment, the recommendations above quoted were embodied in the taxing act as finally passed. Section 6 of the Bank and Corporation Franchise Tax Act (Stats. 1929, c. 13, p. 19) contains the following definition:

"The term 'gross income' as herein used, includes . . . *all interest received from federal, state, municipal or other bonds.* . . ."

Further light on this provision will be found in the statement of Professor Robert M. Haig of Columbia University, who had served as technical adviser to the Tax Commission. In the course of a public hearing on the Senate bill embodying this Act, held on January 17, 1929,* Professor Haig, after stating that "*in the form* in which the law is drafted, it is a tax for the privilege of carrying on business in this state for a year in advance", continued (p. 9):

*Public Hearing on Senate Bills Nos. 509, 510, Relating to Revenue and Taxation, State Printing Office Publication No. 64915. Copies of this publication are filed with the briefs herein.

"Now, as to the definition of net income. You will find this material presented in section 6 and following. In the first place, the definition of income is broad, in one respect, in that it does attempt to include within the scope of the base used as the measure of the tax *income received from tax-exempt securities—that is, government bonds and so on. . . . Interest from tax-exempt bonds is an exceedingly important item* in a tax which is applied to banks. The definition is broad, in that it does include this tax-exempt interest in the base which is used as a measure of the value of the franchise."

In view of these statements, can it be fairly said that the inclusion of such income was merely fortuitous and incidental to the main purpose of the law?

Later, in explaining its opposition to a real estate offset in the new law, the Commission made it clear that the tax was essentially one directly on income as a substitute for personal property taxes, saying (Final Report, pp. 301 and 302):

"The Personal Property Tax Offset a Temporary Adjustment.—One reason why it is undesirable, in the opinion of the Commission, to grant an offset for real estate taxes is found in the fact that under the general plan for the reorganization of the tax system of the state, which the Commission proposes to recommend in its final report, the personal property offset is itself scheduled to disappear. In other words, instead of extending the offset principle, the Commission regards the privilege of offset, which has been granted to personal property, as a *temporary adjustment,* undesirable in itself, which should be eliminated at the earliest practical moment. . . . Consequently, the correct view to take of the situation is that the new franchise tax *is essentially a tax in partial substitution for the*

present taxes on personal property, the local assessment of such property being temporarily continued, because it offers a convenient solution of the problem of allocating the proceeds of this tax. In the view of the Commission, then, *the personal property offset is a temporary arrangement* which will, it is hoped, be abolished upon the adoption of the Commission's recommendations for a *comprehensive tax on the net income of corporations,* the general taxation of their real estate and the modification or *entire elimination of their tax on personal property.*"*

Compare the language of Judge CARDOZO in *People, etc.* v. *Knapp,* 230 N. Y. 48, 57, holding what was there in form a franchise tax was in practical operation a tax on income, especially as the tax was to be in lieu of all other taxes on personal property. "The reason for the apparent exemption was that, *under the form of a tax upon the franchise,* the property of such corporations had already been subjected to its share of public burdens."

In view of this frank exposition of the motives underlying the adoption of the tax on banks and other corporations, and of the real character of the tax imposed, the following language in *Macallen Co.* v. *Massachusetts,* 279 U. S. 620, 625 (holding invalid very similar legislation in that state), seems controlling:

> "As it many times has been decided, neither state courts nor legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect. . . . And this Court must determine for itself by independent inquiry whether the tax here is what, in form and

*Special Report California Tax Commission, January 15, 1929, "An Analysis of the Demand for a Real Estate Tax Offset against the Franchise Tax on Banks and Corporations", bound in the Final Report beginning on page 292, and filed with the briefs herein.

by the decision of the state court, it is declared to be, namely, an excise tax on the privilege of doing business, or, under the guise of that designation, is *in substance and reality a tax on the income derived from tax-exempt securities.*"

Again, on page 629:

"The fact that a tax ostensibly laid upon a taxable subject is to be measured by the value of a non-taxable subject at once suggests the probability that it was the latter rather than the former that the law-maker sought to reach. If inquiry discloses persuasive grounds for the conclusion *that such is the real purpose and effect of the legislation,* the tax cannot be upheld without subverting the well-established rule that ' . . . . what cannot be done directly because of constitutional restriction cannot be accomplished indirectly by legislation which accomplishes the same result.' . . .

"In the consideration of such legislation, the controlling principle, constantly to be borne in mind, is that the state cannot tax the instrumentalities or bonds of the United States, or what is the same thing, the income derived therefrom, directly or indirectly—that is to say, it cannot tax *them in any form.* Words which, literally considered, import a tax upon something else,—a tax, for example, as here, *upon the privilege of doing business measured in part by the amount of non-taxable interest received—may, nevertheless, be adjudged to lay a tax upon the interest, if that purpose be fairly inferable from a consideration of the history, the surrounding circumstances, or the statute itself considered in all its parts.* See *Home Savings Bank* v. *Des Moines,* 205 U. S. 503, 510, 521".

The Court quotes on page 632 from the Massachusetts Special Tax Commission, statements very similar to those

quoted above from the California Tax Commission. Commenting on that report, the Court said: "The effect of the report is that non-taxable bonds nevertheless should be subjected to the burden of the tax; and, since that it could not be imposed directly, the clear intimation is that it be imposed indirectly through the medium of the so-called 'excise'." (P. 633)

It may be urged here, as was done in the *Macallen* case, that there were also legitimate reasons for this legislation, that it was rendered necessary or desirable by section 5219 and that "its real object was, to avoid discrimination forbidden by federal statutes against national banks". A conclusive answer to that contention may be made in the language of this Court in that case (p. 634):

> "But it is enough to say that if such discrimination would otherwise result it must be avoided by some method which does not involve the imposition of a tax which uniformly for a century has been condemned by this Court as unconstitutional. *The state may not save itself from infringing an Act of Congress by violating the Constitution*".

The fact that the State was seeking to comply with the Federal statute furnishes no basis for disregarding the further fact that the effect of this legislation was to impair the obligation of state contracts with reference to exempt bonds. As stated by Mr. Justice LANGDON in the Court below (R. 30): "There can be no doubt but that the California tax commission suggested and the legislature adopted an act including interest from tax-exempt securities in the tax base, because both were convinced that banks and other corporations held such large quantities of these non-taxable securities as to require such a tax base in order

to receive a 'substantial tax' from such entities. The tax was aimed directly at the non-taxable securities and the interest received therefrom".

Equally pertinent is the following language of this Court by Mr. Justice HOLMES in *Miller v. Milwaukee*, 272 U. S. 713:

> "It is a familiar principle that conduct which in usual situations the law protects may become unlawful when part of a scheme to reach a prohibited result. *If the avowed purpose or self-evident operation of a statute* is to follow the bonds of the United States and to make up for its inability to reach them directly *by indirectly achieving the same result,* the statute must fail even if but for its purpose or special operation it would be perfectly good. . . . A result intelligently foreseen and offering the most obvious motive for an act that will bring it about, fairly may be taken to have been a purpose of the act. . . .
>
> "A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack upon their immunity *when they are its obvious aim.* In such a case the court must consider the public welfare rather than the artifices contrived for private convenience, and must look at the facts".

It may be observed in passing that Section 5219 R. S. attempts to give authority to the state to tax only *national* banks, according to or measured by their "net income received from all sources". Even if congress has succeeded by this act in authorizing the states to tax such banks on income from United States bonds, a question still left open (see 279 U. S. at p. 633), certainly Congress has not attempted to nor can authorize the states to tax otherwise

exempt state bonds, either to state or national banks, or to other corporations.

2.

The Constitutional Principles Applied in *Macallen Co.* v. *Massachusetts* Are Conclusive of this Case.

We have already quoted extensively above from the *Macallen* case. The facts in that case and in the case at bar will now be compared. In the history of the legislation involved, in the language of the act as passed, in its evident purpose and in its legal and practical effect, we find no point of material difference. A petition for re-hearing was overruled in the *Macallen* case, after several States, including the State of California, had filed briefs therein (280 U. S. 513). It is clear, therefore, that the question was not only very maturely considered by this Court but the possible bearing of its decision on the California law was called to its attention.

While there are, strictly speaking, certain differences between the Massachusetts and California situations, the differences are of a nature either too trivial to warrant grounding a distinction, or of such a nature that they make out a still stronger case here for the application of the rule recognized in the *Macallen* case than did the Massachusetts statute.

Thus, in California, the inclusion of interest from tax-exempt securities is permitted by an entirely new scheme of taxation, instead of inferentially through amendment of an already existing statutory plan removing the specific exemption of income from the exempt securities as in the

case of Massachusetts. But, as Mr. Justice LANGDON aptly remarked in his dissenting opinion herein:

> "To conclude that this fact alone warrants a distinction between the two cases is to hold that Massachusetts cannot take in two bites what California can have in one" (R. 28).

Again, the California statute includes interest from tax-exempt securities in a manner different from that employed by Massachusetts, but one which makes the intent to reach such income more obvious from the face of the statute than was true of the *Macallen* tax. The California act defines "gross income" as including "all interest received from federal, state, municipal or other bonds" (Cal. Stats. 1929, c. 13, secs. 6 and 7), while "net income" is gross income minus certain deductions, but no deduction is allowed for interest from such securities. The definite intent to reach such income is, therefore, apparent from a reading of the act itself in the case of California. Under the Massachusetts statute, income from Federal securities was reached by a provision defining net income "required to be returned by the corporation to the federal government under the federal revenue act . . . adding thereto . . . all interest and dividends not so required to be returned as net income". (Mass. Stats. 1925, c. 343, Sec. 1 A.) This was an amendment to an act which previously defined net income as that "required to be returned by the corporation to the Federal Government under the Federal Revenue Act . . . less . . . interest so required to be returned, which is received upon bonds . . . of the United States". (Mass. Gen. Laws, 1921, c. 63, Sec. 30 (5).)

The Massachusetts statute under which the tax was levied makes no mention of exempt securities or income

therefrom and is, therefore, less direct than the California one. It takes no reading of the California statute in relation to prior legislation to make it clear that the legislature was intent upon reaching wealth which it could not tax as property. It is also to be noted that under the rule of the *Macallen* case, the Court is not restriced to an examination of the face of the statute in order to analyze legislative motive, but may consider the history of the legislation and its surrounding circumstances. Both the reports of the State Tax Commission and the circumstances surrounding the enactment of the statute, as well as the act itself, plainly show that the aim of the California legislature was to take advantage of Congressional permission given by the 1926 amendment to section 5219 R. S. to levy taxes measured by net income, including interest from tax-exempt securities, on national banks, and to extend this to other banks and corporations, and that the legislature regarded this source of revenue as highly important.

It is clear, therefore, that insofar as there are any differences between the history, form, etc., of the Massachusetts statute and the California statute, the differences make out a stronger case against the validity of the California act.

Correspondingly also the corporation in the *Macallen* case owned a large number of bonds of Massachusetts counties and municipalities which, when issued and acquired by the corporation, were covered by the terms of a state statute (Gen. Laws, c. 59, Sec. 5, Par. 25), providing that bonds of the Commonwealth and its subdivisions "shall be exempt from taxation".

In the *Macallen* case, this Court reached the conclusion that as to the tax on Federal bonds, the act was in derogation of the constitutional power of Congress to borrow

money on the credit of the United States, as well as in violation of the act of Congress declaring such bonds to be non-taxable; and as to the county and municipal bonds, that the act impaired the obligation of the statutory contract of the State by which such bonds were made exempt from state taxation.

Bonds of Political Subdivisions of the State.

If anything, it would seem that as to the latter class of bonds mentioned by the Court in *Macallen* v. *Massachusetts,* the case is even stronger than as to Federal bonds. As to State bonds, we are dealing with a very clear, explicit constitutional prohibition against the impairment of the obligation of contracts, and not with an implied constitutional inhibition as to relative sovereignties, and not, therefore, with a mere burden on impliedly exempt subjects where the validity of the tax may, to some extent, depend upon the degree or the weight of the burden. Certainly, when we are dealing with the impairment of the obligation of a contract, the contract is either impaired or it is not. Compare *Gillespie* v. *Oklahoma,* 257 U. S. 501, making a distinction as between burdens on interstate commerce where the degree of the burden may be considered, and on federal instrumentalities, as to which latter the Court said: "In case where the principal is absolutely immune from interference an inquiry is allowed into the sources from which net income is derived and if a part of it comes from such a source the tax is *pro tanto* void. . . ." And as said in *People* v. *Bond,* 10 Cal. 563, 571, where the Court had under consideration the Federal constitutional provision against impairing the obligation of contracts: "The question is not whether by legislative alteration of a

contract a party is to be injured seriously or only slightly; *he has a right to the substance of the contract as he has made it*".

In the leading case of *Green* v. *Biddle*, 8 Wheat. 1, it was said by this Court after the second argument (p. 84):

> "The objection to a law, on the ground of its impairing the obligation of a contract, *can never depend upon the extent of the change which the law effects in it.* Any deviation from its terms, by postponing, or accelerating, the period of performance which it prescribes, imposing conditions not expressed in the contract, or dispensing with the performance of those which are, however minute, or apparently immaterial, in their effect upon the contract of the parties, impairs its obligation."

But the burden is not in fact slight in this case. It is very substantial. More than one-half of appellant's tax is based upon the income from these exempt securities (R. 6, 9); and the Report of the California Tax Commission shows that it was expected that "substantial revenue" would be raised from this very source. These considerations make it all the more important that the Court should scrutinize very carefully acts of this character in order, as stated in the *Macallen* case, "to distinguish between an exaction which, in substance and reality is what it pretends to be, and a scheme to lay a tax upon a non-taxable subject by a deceptive use of words" (p. 629).

Relying upon the provisions in Article XIII of the State constitution that such bonds "shall be free and exempt from taxation", the purchasers and holders of such bonds were warranted in feeling secure that such bonds would, in fact, be so free from taxation; and by free and exempt from taxation was meant free and exempt from all kinds of taxes,

and not merely free from all kinds except what the State might please to label a franchise tax.

The State has attempted to tax bonds which, by its constitution, it had declared to be non-taxable and which it had sold to the public under a solemn assurance that no taxes would be imposed thereon. It was to prevent just such an act by a State that the prohibition was embodied in our Federal constitution. We cannot believe that a State may be permitted thus to repudiate or impair its contracts by the device of a so-called "franchise" tax and thereby to reduce the value of its obligations in the hands of innocent holders.

To quote the vigorous language of Chief Justice TANEY in *Bronson* v. *Kinzie*, 1 How. 311, 318, in referring to this constitutional provision:

> "And it would be unjust to the memory of the distinguished men who framed it, to suppose that it was designed to protect a mere barren and abstract right, without any practical operation upon the business of life. * * * It was to maintain the integrity of contracts, and to secure their faithful execution throughout this Union, by placing them under the protection of the Constitution of the United States."

The Court quotes with approval from the opinion of Mr. Justice STORY in the earlier case of *Green* v. *Biddle*, 8 Wheat. 1, 17:

> "It is no answer that the Acts of Kentucky now in question are regulations of the remedy and not of the rights to the land. If those acts so change the nature and extent of existing remedies, as materially to impair the rights and interests of the owner, they are just as much a violation of the compact, as if they *directly overturned his rights and interests.*"

3.

Other Leading Decisions of This Court Plainly Show that Appellant is Entitled to Prevail in this Suit.

No rule in conflict with that laid down in the *Macallen* case can be derived from prior or subsequent decisions of this Court. In fact, we need look no further than the opinion of the Court in the most recent of these decisions, *Educational Films Corp.* v. *Ward,* 282 U. S. 379, to find a reconciliation of any apparent conflict and a reaffirmance of the rule of the *Macallen* case. The test as stated in *Miller* v. *Milwaukee, supra,* still is whether "the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result,—whether the tax is "aimed at" the exempt property (as quoted with approval in the *Educational Films* case, p. 393).

The *Educational Films* case involved the validity of a New York franchise tax. In the particular instance the income by which the tax was measured included royalties from copyrights granted by the United States, on which ground the appellant objected to the tax. There was nothing either on the face of the Act or in its legislative history to show that the legislature even had in mind the income from copyrights. As the Court pointed out in upholding the tax, "it cannot be said that the present tax was aimed at copyrights." After referring to certain amendments to the New York laws, the Court continued (p. 394):

> *"There is nothing to suggest that the legislature could at any time have had in mind the addition of income from copyrights to the measure of the tax,* or

that the statute or the amendment were adopted '*for the very purpose* of subjecting' it *pro tanto* to the burden of the tax', which was declared to be the vice of the statute in *Macallen Co.* v. *Massachusetts, supra,* p. 631. That the royalties play some part in the measure of the tax is the result of the application of the general language of the statute to particular circumstances *to which the statute makes no specific reference.* In this respect, the present statute differs in no substantial way from that upheld in *Flint* v. *Stone Tracy Co., supra.*" [220 U. S. 107.]

Referring to the contention that the *Macallen* case was a departure, the Court said (p. 392):

"That case did not overrule *Flint* v. *Stone Tracy Co., supra.* Instead, the opinion rested the decision on the distinguishing fact that the tax exempt securities were included in the measure of the franchise tax by virtue of an amendment to the taxing statute which, it was held, *was specifically intended to reach the income from tax-exempt national and municipal bonds* which had previously not been included in the measure of the tax. The case was thus brought within the purview of *Miller* v. *Milwaukee,* 272 U. S. 713. * * *" (The Court after quoting therefrom part of the language quoted above, p. 20, continued): "But, as the court in that case was careful to point out, in language later quoted with approval in *Macallen Co.* v. *Massachusetts,* p. 631, 'A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and *not aimed* at them'. . . . It cannot be said that the present tax was aimed at copyrights."

On the other hand, no one can seriously deny that the present tax was very definitely *aimed at* the income from exempt securities. The legislature was "gunning" for this

very income, and was frank enough so to state. Both the Constitution and the State taxing acts were amended for the admitted purpose of reaching the income from tax-exempt bonds. Before those amendments, as the State Board of Equalization pointed out in one of its opinions, Appeal of *Vortox Manufacturing Company* (Prentice-Hall California Corporation Tax Service, 1930, par. 11045, reprinted in the Appendix hereto), there was not even an attempt by the State taxing authorities to reach such exempt property, the Board saying: "There is no basis for the assertion that our Board taxed as a part of the value of general corporate franchises, property exempted from taxation under the laws of this state or of the United States."

So it may be here said, as in the *Macallen* case, that "this was a distinct change of policy on the part of the Commonwealth, adopted, as though it had been so declared in precise words, for the very purpose of subjecting these securities *pro tanto* to the burden of the tax". In fact, in the case at bar, the change was declared in precise words, if we are to give any meaning to the quotations herein made from the reports of the State Tax Commission and from the Act itself. The tax must be held to be invalid if the legislative purpose to lay the tax upon the non-taxable subject "be fairly inferable from a consideration of the history, the surrounding circumstances, or the statute itself considered in all its parts" (279 U. S., p. 629).

We have probably said enough to show that *Flint* v. *Stone Tracy*, 220 U. S. 107, is not in conflict with our contentions herein, or with the holding of this Court in the *Macallen* case. While this Court has referred to *Flint* v. *Stone Tracy* as "the extreme example" of the doctrine that taxes may be measured by income, although a part of such income is derived from non-taxable income (279

U. S., p. 628), the facts in that case put it in the class with the *Educational Films* case. In other words, in the *Stone Tracy* case there was not the slightest evidence that the legislative purpose was to lay a tax on a non-taxable subject.

In distinguishing that case and also *Home Ins. Co.* v. *New York*, 134 U. S. 594; *Society for Savings* v. *Coite*, 6 Wall. 594; and *Provident Institution* v. *Mass.*, 6 Wall. 611, this Court said in the *Macallen* case (p. 628):

> "The distinction pointed out in these cases is between an attempt to tax the property or income *as such* and to measure a legitimate tax upon the privileges involved in the use thereof. It is implicit in all that the thing taxed in form was in fact and reality the subject aimed at, and that any burden put upon the non-taxable subject by its use as a measure of value was *fortuitous and incidental.*"

Apparently, the first State law to come before this Court, relying for its validity upon the *Stone Tracy* case, was the Wisconsin statute considered in *Miller* v. *Milwaukee*, 272 U. S. 713 (1927). In that case one law taxed corporations on their income, except the income from federal bonds, while another taxed dividends received by stockholders only in so far as those dividends *or the income from which they were paid, were not taxed to the corporation.* This Court held the latter law invalid as an attempt to levy a tax on federal obligations, using the language we have quoted above, p. 20, to which we would particularly refer.

Another case to come before this Court in which a party was relying upon the *Stone Tracy* case, was *Northwestern Mutual Life Insurance Co.* v. *Wisconsin*, 275 U. S. 136, decided in November, 1927. In that case, Wisconsin imposed a license or franchise tax on life insurance companies of 3

per cent. of the gross income from all sources. This Court, in a unanimous opinion, without mentioning the history of the law, held it to be invalid as a tax on federal bonds, to the extent that interest from such bonds was included.

It is true that the Court in its opinion adverted to the fact that the tax was on gross income; but that this fact was in no wise controlling, is shown by the decision of this Court in the *Macallen* case, where the tax was on net income and in which opinion, Mr. Justice McReynolds, who wrote the opinion in the above case, concurred. See also *Gillespie* v. *Oklahoma*, 257 U. S. 501 (1922). Since the first *Pollock* case, 157 U. S. 429 (1895), it seems to be settled doctrine that income from Government bonds is as immune from a tax on net income as from a tax on gross receipts. In fact, net income from bonds is seldom likely to be much less than gross income therefrom. As a practical matter, so long as the taxpayer makes a profit from business operations, there would be a tax measured by its net income from exempt bonds which would be about as large as if measured by the total interest therefrom. The borrowing power of the United States would not be greatly relieved by an immunity confined to bonds in the hands of unsuccessful business operators.

In addition to the foregoing authorities, we might mention, without further discussion, the following cases cited by this Court in the *Macallen* case and which furnish strong analogies to the case at bar or which lay down the same governing principles:

Weston v. *Charleston*, 2 Pet. 449;
Home Savings Bank v. *Des Moines*, 205 U. S. 503;
Choctaw & Gulf R. R. v. *Harrison*, 235 U. S. 292;
Galveston, etc. Ry. Co. v. *Texas*, 210 U. S. 217;

Cook v. *Pennsylvania*, 97 U. S. 566;
Almy v. *California*, 24 How. 169;
Indian Oil Co. v. *Oklahoma*, 240 U. S. 522;
Federal Land Bank v. *Croslan*, 261 U. S. 374;
Fairbank v. *United States*, 181 U. S. 283;
Alpha Portland Cement Co. v. *Massachusetts*, 268 U. S. 203;
Frick v. *Pennsylvania*, 268 U. S. 473;
National Life Ins. Co. v. *United States*, 277 U. S. 508.

In many of these cases there were involved laws which attempted to "measure" the tax imposed by the use of a non-taxable subject and all of which were held invalid. See also *Western Union Tel. Co.* v. *Kansas*, 216 U. S. 1; *Owensboro National Bank* v. *Owensboro*, 173 U. S. 664.

Conclusion.

There are many other cases bearing more or less directly on the issue herein, but in the last analysis it would seem unnecessary to look beyond the *Macallen* case for guidance. There is no room for analogy or inference in the face of a direct authoritative decision on the exact point at issue. The distinction advanced before the Court below, that there were two acts in Massachusetts and only one in California is no distinction at all. We do not anticipate that the Court will create the illogical situation that California may do exactly what it was held Massachusetts could not do, merely because previously Massachusetts had done something else. Insofar as it is a question of legislative purpose, this purpose can be shown as clearly by one act as by a dozen.

We have discussed the various tests which have been considered in approaching this problem.

If the test is the degree or weight of the burden on the exempt securities imposed by the tax, a case could scarcely be much stronger than the present.

If the test is whether the tax "is in substance and reality a tax on the income derived from tax-exempt securities" (279 U. S., p. 626), the facts showing such to be the character of the tax seem fairly conclusive.

If the test is the motive or purpose of the legislature to reach the exempt securities and tax them, that purpose was repeatedly and unequivocally stated in the course of framing the California law.

If the test is the history and the course of the legislation itself, we have a well-nigh perfect parallel with the similar legislation of Massachusetts, held invalid by this Court; the points of difference making an even stronger case against the California law. And these several tests are really one in this case. That is to say, the fact that the legislature deliberately set out and intended to reach this exempt income is enough to carry conviction that the consequent burden thereon was likely to be and was very substantial and not merely "fortuitous and incidental".

Finally, if broad considerations of policy are to have controlling weight, we would urge that the need to examine taxing acts to see that the use of tax-exempt subjects as a measure for taxes imposed in terms upon taxable subjects is not in reality a cloak, under which the former in substance and effect are taxed, was never more imperative than now when by reason of increased and increasing public expenditures, states and municipalities are driven to search in every direction for additional sources of revenue.

If this legislation is upheld, no great ingenuity will be required to frame laws that will subject to heavy and de-

structive taxes, securities, state and federal, which have been issued under constitutional guaranties of tax exemption.

In substance, though not in form, in effect, though not in name, this tax is a direct tax on exempt income; whether we regard this as a franchise tax or a thinly disguised tax on the income itself, the legal and the practical result is the same, a serious burden deliberately laid on a subject constitutionally exempt from tax. Both in form and substance it is a tax on the source of the income *qua* the exempt source; and such a tax this court has never upheld.

We respectfully request, therefore, a reversal of the decision of the lower Court.

STUART CHEVALIER,
Counsel for the Appellant.

MELVIN D. WILSON,
MILLER, CHEVALIER, PEELER & WILSON,
Of Counsel.

APPENDIX.

IN MATTER OF APPEAL OF VORTOX MANUFACTURING COMPANY

(STATE BOARD OF EQUALIZATION, AUG. 4, 1930)

APPEARANCES:

For appellant, MESSRS. NICHOLS, COOPER AND HICKSON.

For Respondent, HON. REYNOLD E. BLIGHT, *Franchise Tax Commissioner.*

OPINION.

This is an appeal under Section 25 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929) from the action of the Franchise Tax Commissioner in overruling the protest of Vortox Manufacturing Company against a proposed assessment of an additional tax of $4,110.54, with interest.

The sole point involved in this appeal is whether amounts received as royalties for the use of patent rights issued by the United States Government are subject to inclusion in the tax base under this statute. The Commissioner has proceeded in reliance upon language of the Act which apparently authorizes him to include such income, while the taxpayer protests that this procedure is violative of the Constitution of the United States. The question is of paramount importance and presents itself in many similar appeals. Consequently, we have deferred our decision until now so that we might be afforded opportunity for mature deliberation on the problem.

Section 4 of the Act specifies that certain classes of corporations, in which appellant is apparently included,

must pay annually to the State a tax "according to or measured by" their net income, less certain offsets for property taxes paid locally. "Net income" is defined in Section 7 of the Act as the "gross income", less allowable deductions. "Gross income" is defined in Section 6 of the Act as follows:

> "The term 'gross income', as herein used, includes gains, profits and income derived from the business, of whatever kind and in whatever form paid; gains, profits or income from dealings in real or personal property; gains, profits or income received as compensation for services, as interest, rents, commissions, brokerage or other fees, or otherwise received in carrying on such business; all interest received from federal, state, municipal or other bonds, and, except as hereinafter otherwise provided, all dividends received on stocks."

There is no provision in the Act for the deduction of income from tax-exempt sources. For this reason, the Commissioner has insisted upon the inclusion of the royalties from patent rights, although it is obvious that the patents themselves are not taxable. (*Long* v. *Rockwood,* 277 U. S. 142.) The appeal is based upon the proposition that inclusion of patent royalties in the tax base is, in effect, taxation of income from a federal instrumentality.

In support of this view the appellant cites two recent decisions of the United States Supreme Court. One of these, *Long* v. *Rockwood,* 277 U. S. 142, holds that a state may not tax directly royalties from patents. The other, *Macallen* v. *Massachusetts,* 279 U. S. 620, holds that, under the guise of an excise tax measured by net income, a state may not tax income from exempt sources, such as federal and state bonds, thereby accomplishing by indirection what it is forbidden to do directly.

Each of these cases involves taxing statutes of the Commonwealth of Massachusetts, and the Franchise Tax Com-

missioner seeks to differentiate the "history" of the effort to reach tax-exempt income by "excise" taxation there and in California. We do not find the "differences" urged particularly convincing. It is true that the taxation of income from exempt sources was sought to be accomplished in Massachusetts through amendment of an existing excise statute rather than through adoption of an entirely new law as in California. But to make this a vital point of difference would be virtually to hold that Massachusetts may not take in two bites what California may have in one.

Analyzing the former tax on general corporate franchises assessed under Section 3664d of the Political Code, the Franchise Tax Commissioner has attempted to show that under it the tax-exempt property of corporations was actually included in the value of the corporate franchises as ascertained by our Board. This reveals a lack of understanding of what constitutes the value of a corporate franchise, because the constitutional and statutory provisions under which we proceeded certainly did not contemplate that the franchise value of corporations would be increased through their ownership of exempt property. In arriving at the worth of a corporate franchise we were required to ascertain the total worth of the corporation through the known value of its stocks and bonds, capitalization of its net earnings or some other accepted method. From this total corporate worth we deducted the intrinsic value of its assets, including tax-exempt property, in order that we might arrive at the corporate "excess", which had been established as the proper basis for franchise assessment. (*Miller & Lux* v. *Richardson*, 182 Cal. 115.) Certainly, this "corporate excess" or franchise value could not be said to include the value of tax-exempt property.

Our forms for report, prepared under the provisions of Section 3667 of the Political Code, called explicitly for "the market or actual value of non-assessable real and per-

sonal property owned by the company" on the assessment date. They also called for the income received from this type of property. These factors were required for the express object of assuring that we should be in a position to make due allowance for the ownership of such property and the income derived therefrom when valuing corporate franchises. There is no basis for the assertion that our Board taxed as a part of the value of general corporate franchises property exempted from taxation under the laws of this state or of the United States.

So far as the policy of the state with reference to taxation of banks is concerned, any inference to the effect that exempt property was taxed under subdivision (*c*) of Section 14 of Article XIII of the Constitution or Section 3664c of the Political Code is drawn in apparent disregard of the fact that these provisions called for a tax on bank shares and not on banks themselves. It is a fundamental conception of the law that a tax on the stock of a corporation is not rendered unconstitutional because the corporation owns securities which are exempt from taxation, while a tax on those same securities, or on the income therefrom, would be invalid. (*Bank of California* v. *Roberts,* 248 U. S. 492.) It has been held that a tax upon bank stock is not a tax on exempt securities, even though the value of the stock may be influenced through the ownership of such securities by the bank. (*Des Moines National Bank* v. *Fairweather,* 263 U. S. 103.) Therefore, we find nothing in the "history" of California taxation which justifies the conclusion that we have taxed in the past, either corporations generally or banks particularly, on account of their ownership of tax-exempt property.

Concerning the auspices under which the present tax on banks and corporations "according to or measured by" their net income was introduced, only brief comment need be made. In its report recommending the plan to the Legislature the Special Tax Commission created under Chapter

455, Statutes of 1927, discussed its reasons for proposing the adoption of the measure. It said that the share tax method then employed with reference to banks was probably invalid, citing the case of *Merchants National Bank of Richmond* v. *Richmond,* 256 U. S. 635. It discussed the four alternatives allowable under Section 5219, U. S. Revised Statutes, relating to state taxation of national banks, and concluded that "the only practicable method of securing a substantial revenue from the banks is to proceed under the fourth method permitted by the federal statutes, and tax banks 'according to or measured by net income.'" (Final Report of the California Tax Commission [March 5, 1929], p. 247.)

Discussing the origin of this method, the Commission said:

> "The original proposal for this amendment was prepared and submitted to the congress as a result of the joint activities of a committee of the American Bankers Association and a committee of the National Tax Association. The known purpose of these committees was to modify the 1923 amendment so as to permit a law such as the franchise tax on income of corporations in force in New York state to be applied to national banks. This intention is also plainly stated in the report of the House Committee on Banking and Currency." (Final Report of the California Tax Commission [March 5, 1929], p. 259.)

Rejecting as undesirable the taxation of banks and corporations directly on their net income under the third alternative provided by Section 5219 of the U. S. Revised Statutes, the Commission assigned its reasons as follows:

> "The third method may be discarded in favor of the fourth, because under the fourth everything can be accomplished which may be gained by proceeding under the third, and presumably more besides, viz., the inclusion, if desired, of tax-exempt interest in the base."

Appendix.

(Final Report of the California Tax Commission [March 5, 1929], p. 264.)

Continuing its discussion of the problems involved, the Commission said:

> "As has been pointed out, the 1926 amendment to Section 5219 was drafted with the avowed object of permitting the inclusion in the tax base of such income as the interest from tax-exempt bonds. The point, however, has not been adjudicated and a suit (The *Macallen Company* v. *Commonwealth of Massachusetts*) has already been filed in Massachusetts questioning the right of a state to include such interest.
>
> "In the case of corporations other than banks, the point is not of vital importance. But the banks hold such large quantities of these tax-exempt bonds that the effect of a decision holding that the state may not include them in the base would be very serious indeed. An analysis of the replies of the banks to the Commission's questionnaire indicates that the non-inclusion of federal bond interest would reduce the tax base of the banks approximately one-fourth and the non-inclusion of all interest exempt from the federal income tax would reduce that base by more than one-half." (Final Report of the California Tax Commission [March 5, 1929], p. 276).

Later, in explaining its opposition to a real estate offset in the new law, the Commission made it clear that the tax was essentially one on income as a substitute for personal property taxes, saying:

> "The Commission regards the privilege of offset, which has been granted to personal property as a temporary adjustment, undesirable in itself, which should be eliminated at the earliest practical moment. * * * The correct view to take of the situation is that the new franchise tax is essentially a tax in partial substitution

for the present taxes on personal property, the local assessment of such property being temporarily continued, because it offers a convenient solution of the problem of allocating the proceeds of this tax." (Final Report of the California Tax Commission [March 5, 1929], pp. 301, 302.)

This frank exposition of the motives underlying the adoption of the tax on banks and corporations "according to or measured by" their net income is closely reminiscent of the language employed by the Massachusetts Tax Commission and commented upon by the United States Supreme Court in its decision of the *Macallen* case (*supra*). Consequently, this part of the "history" of the California Act, to our discernment, does not differ vitally from what transpired in Massachusetts.

However, it is plain that our law contemplates the inclusion of income from exempt sources in the tax base. If we should rule that the Commissioner erred in making the additional assessment to accomplish such inclusion, we should have to do so upon the assumption that the Act is unconstitutional.

The power to declare a law unconstitutional is one of the highest attributes of judicial authority. Although we sit in these matters as a quasi-judicial body, and must decide questions of law as well as of fact, we should not lose sight of the ultimate fact that we are not a Court but merely an administrative Board. The right of a ministerial office to question the constitutionality of a statute is generally denied. (6 R. C. L. 92.)

It is true that we have occasionally asserted that right. But this has been only under circumstances wherein such action on our part was necessary in order to protect the revenues of the state and get the problem before the Courts. (*Miller & Lux* v. *Richardson*, 182 Cal. 115.) In the instant case, and in all others like it before us, the taxpayers will

have the opportunity of taking the question to the Courts for decision. (Stats. 1929, Chapter 13, Sec. 30.)

It might be argued that, if the law is plainly unconstitutional, why should taxpayers be put to that trouble and expense? However, there is diversity of opinion as to the constitutionality of the Act, and it seems to us desirable that this controversy should be settled by the Courts, whose authority to hold acts of the Legislaure invalid cannot be questioned.

Much reliance is placed by the Commissioner on the decision of the United States District Court for the Southern District of New York on June 6, 1930, in the case of *Educational Films Corporation of America* v. *Ward,* Fed. (2d) (reported in United States Daily in the issue of Friday, June 6, 1930, at p. 9), declaring that a taxing statute of New York similar to ours does not violate the Federal Constitution though it includes income derived from federal copyrights in the tax base. This ruling is being vigorously contested and will be carried to the higher courts.

On the other hand, the Supreme Court of Washington, in an opinion handed down June 12, 1930, in the case of *Aberdeen Savings & Loan Assn.* v. *Chase,* . Pac. (reported in United States Daily in the issue of June 20, 1930, at page 9, *et seq.* and June 21, 1930, at page 9), held that an income tax measure of that state patterned after the California statute, save as to the classes of corporations included, is invalid as an attempt to tax income from exempt sources.

Expressing much the same view, the Supreme Court of Tennessee in a decision rendered on June 28, 1930, in the case of *Quicksafe Manufacturing Corporation* v. *Graham,* S. W. (reported in United States Daily in the issue of July 23, 1930, at page 8), held that a corporate excise tax, measured by net income, may not be based upon royalties from patents.

These decisions are indicative of the diversity of opinion to which we have already alluded. In view of all the surrounding circumstances, we do not feel warranted in deciding that, under the California Bank and Corporation Franchise Tax Act, income from exempt sources may not be included in the tax base.

ORDER.

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of Reynold E. Blight, Franchise Tax Commissioner, in overruling the protest of Vortox Manufacturing Company, a corporation, against a proposed assessment of an additional tax of $4,110.54, with interest, under Chapter 13, Statutes of 1929, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of August, 1930, by the State Board of Equalization.

R. E. Collins, Chairman; H. G. Cattell, Member; Jno. C. Corbett, Member; Fred E. Stewart, Member.

(From Prentice-Hall State Corporation Tax Service, Par. 11,045.)